BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

June 2003

The International Accounting Standards Board met in Rome on 16 – 18 June 2003, when it discussed:

- Business combinations
- Consolidation (including SPEs)
- Convergence issues
- Financial instruments
- IFRIC issues
- Reporting comprehensive income
- Revenue recognition
- Share-based payment

In addition, it met the Standards Advisory Council on 19 and 20 June 2003. A full report of that meeting will be included in a forthcoming issue of *IASB Insight*.

Business combinations (phase I)

Analysis of comments received on ED 3

The Board discussed the analysis of comments received in response to the questions in the Invitation to Comment on ED 3 *Business Combinations*.

Scope

ED 3 proposed to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control. After considering the comments received, the Board confirmed these scope exclusions.

The Board considered whether it should proceed with the proposed amendments to the definition of joint control in IAS 28 *Accounting for Investments in Associates* and IAS 31 *Financial Reporting of Interests in Joint Ventures*. The Board noted that the proposed definition might be too narrow, ie that it could be read as requiring unanimous consent for all financial and operating decisions. On the other hand, the current definition might make it easier for an entity to structure a business combination as a joint venture to circumvent the proposals in ED 3. The Board agreed that it should continue its consideration of this issue at a later meeting and asked the staff to explore further the definition of joint control.

ED 3 also proposed to include a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions. After considering the comments received, the Board confirmed the definition and guidance.

Method of accounting for business combinations

The Board confirmed its decision to prohibit the use of the uniting (pooling) of interest method and to require all business combinations within the scope of the IFRS to be accounted for by applying the purchase method.

Reverse Acquisitions

The Board confirmed that all pertinent facts and circumstances should be considered when determining whether a business combination is a reverse acquisition, and agreed that the IFRS should include examples clarifying this matter.

The Board agreed to clarify that reverse acquisition accounting applies only in the consolidated financial statements. Therefore, in the legal parent's separate financial statements, the investment in the legal subsidiary is accounted for in accordance with the requirements in [draft] IAS 27 *Consolidated and Separate Financial Statements* on accounting for investments in an investor's separate financial statements.

Identifying an acquirer when a new entity is formed to effect a business combination

The Board confirmed its previous decision that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available. Moreover, the Board agreed to clarify in the final IFRS that this requirement also applies to business combinations involving more than two (pre-existing) entities.

Provisions for terminating or reducing the activities of the acquiree

The Board considered the arguments put forward by commentators on its proposal to recognise a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

The Board noted the arguments put forward by some commentators in support of recognising restructuring provisions that were not liabilities of the acquiree at the acquisition date. These issues were considered in the development of ED 3 and the Board did not agree with the arguments advanced. Therefore, the Board unanimously confirmed its decision to require a restructuring provision to be recognised as part of allocating the cost of a combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37.

The Board also considered whether a restructuring plan of an acquiree whose execution is conditional upon the entity being acquired in a business combination is a present or a possible obligation, which may be recognised as a contingent liability at its fair value as part of allocating the cost of the business combination. The Board concluded that such restructuring plans do not meet the definition of a liability or the definition of a contingent liability. However, to avoid any confusion or possibility of circumventing the Board's intention in relation to the treatment of restructuring provisions, the Board unanimously agreed to clarify this issue in the IFRS.

Contingent liabilities

ED 3 proposed that an acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably.

The Board discussed the main objections against the proposal put forward by commentators, including (a) the lack of consistency with the IASB *Framework* and IAS 37, and (b) the asymmetrical accounting for contingent liabilities and contingent assets. The Board observed, however, that

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

IASB Publications Department,
30 Cannon Street, London, EC4M 6XH
United Kingdom
Tel: +44 (0)20 7332 2730
Fax: +44 (0)20 7332 2749
E-mail: publications@iasb.org.uk
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Business combinations (phase I) *(continued)*

although many commentators disagreed with the proposal, many agreed with the proposal.

The Board confirmed its decision relating to the recognition of contingent liabilities as part of allocating the cost of a business combination.

The Board also considered its proposal subsequently to measure contingent liabilities recognised as part of allocating the cost of a business combination at their fair values, with changes in fair value recognised in profit or loss. Some Board members noted that this proposal was inconsistent with the accounting for financial guarantees under the proposed improvements to IAS 39 *Financial Instruments: Recognition and Measurement*, and suggested that contingent liabilities should be subsequently measured at the higher of their initially recognised amount or their value determined in accordance with IAS 37. Other Board members preferred the proposal in ED 3.

The Board agreed that it should consider the subsequent measurement of such contingent liabilities at a later meeting, and asked the staff to explore this issue further.

Minority interests in the acquiree

The Board unanimously confirmed its decision to require the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a combination to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interests in the acquiree would be stated at the minority's proportion of the net fair values of those items.

Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

The Board considered the objections put forward by commentators on its proposal relating to the treatment of any excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities; in particular, the proposal that an acquirer, after reassessing the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination, should recognise any remaining excess immediately in profit or loss.

The Board discussed the interaction between an excess and expectations of future losses. One view expressed was that an excess could be recognised as "negative goodwill" and subjected to a "negative impairment test". Others noted that expectations of future losses would be reflected in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. The Board concluded by confirming its decision that an acquirer, after reassessing the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination, should recognise any remaining excess immediately in profit or loss.

The Board also considered the suggestion that the term "an excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities" should be replaced with a less cumbersome term, such as 'a discount arising in a business combination'. However, the Board decided against any such change.

Completing the initial accounting for a business combination and subsequent adjustments to that accounting

The Board considered comments received on the proposal that if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs, any adjustments to those values as a result of completing the initial accounting should be recognised within 12 months of the acquisition date.

A view was expressed that a 12-month period might be too short for some business combinations. The Board agreed, however, that a "cut-off" period is needed and that any such period, no matter how long, would be arbitrary.

The Board therefore confirmed its decision that any adjustments to complete the initial accounting for a business combination should be recognised within 12 months of the acquisition date.

The Board also confirmed its decision that, with some specified exemptions, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error.

Finally, the Board agreed to clarify in the IFRS that if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs, subsequent adjustments to the carrying amounts of the acquiree's assets, liabilities and contingent liabilities to complete the initial accounting should be made retrospectively as from the acquisition date.

Project plan

The Board considered a project plan prepared by the staff. The project plan proposed that:

- the Board should consider at its July 2003 meeting the analysis of comments received on the accounting for goodwill;
- the Board should consider at its September 2003 meeting the analysis of comments received on the accounting for intangible assets;
- the Board should consider at its October 2003 meeting the analysis of comments received on disclosures about cash-generating units containing goodwill or intangible assets with indefinite useful lives, and the analysis of comments received on any other issues;
- the Board should consider at its November 2003 meeting the analysis of any other issues identified by the staff or Board members during the above redeliberation process; and
- publication of the final Standards would take place in the first quarter of 2004.

The Board approved the plan for finalising phase I of the Business Combinations project.

Business combinations (phase II)

Full goodwill method

In November 2002 the Board agreed that the full goodwill method should be used to recognise goodwill in the acquisition of less than a 100 per cent controlling interest in the acquired entity. Under the full goodwill method, all of the goodwill of the acquiree, including goodwill attributable to minority interests, is recognised. Goodwill is measured as the difference between the fair value of the acquiree as a whole and the net fair value of all of its identifiable assets and liabilities at the date control is obtained.

In June 2003 the Board discussed further the implications of applying the full goodwill method, possible alternatives to the full goodwill method, and the issues that would need to be resolved under these possible alternatives.

After considering those implications, alternatives and issues, the Board confirmed its previous decision that the full goodwill method should be used.

Fair value hierarchy

The US Financial Accounting Standards Board and the IASB, in accepting the working principle for this project, agreed to use fair value as the measurement objective for valuing the assets acquired and liabilities assumed in a business combination.

The boards also agreed that their exposure drafts resulting from this joint project should provide guidance for measuring fair value in the form of a hierarchy to ensure the consistent application of the fair value working principle.

Recently, as part of a broader consideration of fair value measurement issues, the FASB agreed to amend the fair value hierarchy. At its June 2003 meeting, the IASB considered whether, in the interests of convergence, it also should amend the fair value hierarchy to incorporate the FASB's amendments.

The IASB agreed with the proposed amendments to the hierarchy. Specifically, the IASB agreed:

(a) to emphasise that market prices, when available, are considered to be the best evidence of fair value.

(b) to introduce a definition of marketplace participants as follows:

    A marketplace participant is an entity that has utility for the item (or group of items) being valued, has the legal and financial ability to complete a transaction in the form contemplated, and is willing to complete the transaction (the willing parties in the definition of fair value). The marketplace participant is hypothetical and does not represent the biases of a particular participant, but rather reflects the notional consensus of the market.

(c) to clarify that, when fair value estimates are determined based on the results of valuation techniques, those techniques should maximise market inputs and minimise entity-specific inputs. Specifically, the hierarchy will emphasise the preference for multiple valuation techniques if sufficient information necessary for their application is available without undue cost or effort.

(d) to make some other clarifications.

Consolidation (including SPEs)

The Board considered a draft project plan for consolidation (including special purpose entities (SPEs)). It was noted that the project would result in an IFRS replacing [draft] IAS 27 *Consolidated and Separate Financial Statements*. The standard would address consolidation of both SPEs and non-SPEs.

The Board agreed that the project should begin by considering the definition of control to be used as the basis for consolidation in the new standard.

Consideration will then be given to whether effective control (being the ability to exert control) rather than legal control (being the current holding of a majority of voting rights) will be the basis for consolidation. This will include consideration of:

(a) whether the holder of 50 per cent or fewer voting rights controls an entity if the balance of voting is widely dispersed and does not vote collectively

(b) control via contract

(c) the relevance of potential voting rights held through options or convertible securities.

Based on the concept of control developed in the initial phase of the project, the circumstances in which SPEs should be consolidated will then be determined.

The Board then considered the outline of an exposure draft to confirm the scope of issues to be included within the project and to identify further issues for consideration. The outline summarised the concept of control previously tentatively agreed by the Board and the decisions made in Business Combinations phase II in relation to minority interests.

The Board tentatively confirmed its preference that consolidation principles should be included in the main body of the IFRS, with more detailed guidance (including that relating to consolidation procedures) included in appendices or application guidance.

Convergence issues

Disposal of non-current assets and reporting of discontinued operations

The Board agreed that the proposed ED *Disposal of Non-current Assets and Reporting of Discontinued Operations* should include a consequential amendment to [draft] IAS 27 *Consolidated and Separate Financial Statements* removing the exemption from consolidation for subsidiaries acquired and held exclusively with a view to their subsequent disposal.

IAS 12 *Income Taxes*

The Board continued its discussions of differences in the exceptions to the basic principle between IAS 12 *Income Taxes* and FASB Statement 109 *Accounting for Income Taxes*. The Board discussed four specific issues relating to deferred taxes.

Goodwill and negative goodwill

Both IAS 12 and FAS 109 provide an exception to the basic principle whereby an entity is prohibited from recognising a deferred tax liability related to goodwill (or the portion thereof) for which amortisation is not deductible for tax purposes and negative goodwill. The Board considered whether to eliminate this exception but decided not to amend IAS 12 because (i) it is already converged with US GAAP, (ii) there are practical difficulties with tracking goodwill into perpetuity, and (iii) often there may not be a difference between the tax base and the carrying amount, given that a tax deduction equal to the cost of the investment is usually available on the sale of the investment.

Investments in subsidiaries, branches, associates, and interests in joint ventures

The Board continued its discussion from the April meeting of the exceptions to the basic principle in IAS 12 for taxable temporary differences for investments in subsidiaries and interests in joint ventures. The Board agreed that there were two tax bases relating to assets and liabilities held by a subsidiary: the tax base of the assets and liabilities from the subsidiary's perspective and the tax base of those assets and liabilities from the parent's perspective. The Board did not reach any further conclusions on these issues and directed the staff to prepare a follow-on paper addressing the question of consistency of treatment of withholding taxes and practical problems arising on foreign subsidiaries for the Board to consider at a future meeting.

Intercompany transfers

An intercompany transfer of assets (such as the sale of inventory or depreciable assets) between tax jurisdictions is a taxable event that establishes a new tax base for those assets in the buyer's tax jurisdiction. The new tax base of those assets is deductible on the buyer's tax return as those assets are consumed or sold to an unrelated party. US GAAP requires taxes paid by the seller on intercompany profits to be deferred and prohibits the recognition of a deferred tax asset for the difference resulting from tax base differences between the jurisdictions. IAS 12 does not provide a similar exception. The Board decided not to amend IAS 12 to provide for this exception. The Board also directed the staff to work with the FASB to establish whether the FASB would amend FAS 109 to eliminate this exception.

Foreign non-monetary assets and liabilities

US GAAP prohibits recognition of a deferred tax asset or liability for differences related to assets and liabilities that, under FAS 52 *Foreign Currency Translation*, are remeasured from the local currency into the functional currency using historical exchange rates and that result from (i) changes in exchange rates or (ii) indexing for tax purposes. In contrast, IAS 12 requires recognition of a deferred tax liability or asset for those temporary differences. The Board decided not to amend IAS 12 to provide for this exception. The Board also directed the staff to work with the FASB to establish whether the FASB would amend FAS 109 to eliminate this exception.

IAS 33 *Earnings Per Share*

The May 2002 exposure draft proposed eliminating paragraph 2 of IAS 33 *Earnings Per Share*, which states that when both consolidated and parent-only financial statements are presented, earnings per share information need be presented only on the basis of consolidated information. The Board expressed concern over whether the presentation of two earnings per share figures (one for the consolidated financial statements and one for the parent-only financial statements) would be misleading. The Board noted that earnings per share based on parent-only financial statements might be useful in limited situations and decided to retain the option currently in IAS 33. The Board also decided that, to avoid confusion, IAS 33 should prohibit presentation of the parent-only earnings per share amounts in the consolidated financial statements (either on the face of the financial statements or in the notes).

At the February 2003 Board meeting, the Board tentatively decided to withdraw several of the proposed amendments to IAS 33 (see February 2003 IASB *Update*) and directed the staff to work with the FASB to establish whether the FASB would (i) consider adding earnings per share to the scope of the short-term convergence project and (ii) consider amending FAS 128 *Earnings per Share* to converge with IAS 33. The Board was advised that the FASB had agreed with the IASB decisions and would amend FAS 128 to converge with IAS 33.

Financial instruments

Improvements to IAS 32 *Financial Instruments: Disclosure and Presentation*

Contracts on own equity

The Board considered whether amendments should be made to the definitions of a financial asset, a financial liability and an equity instrument in IAS 32. The objective of those amendments is to reflect the tentative decisions made by the Board at its April meeting about the classification of financial instruments that are indexed to, or settled in, own equity instruments as assets/liabilities or equity under IAS 32 (see IASB *Update*, April 2003). The Board tentatively agreed to amend the definitions in IAS 32 to reflect those tentative decisions, subject to further consideration of the interaction between the proposals in IAS 32 and ED 2 on share-based payments.

Sensitivity disclosures

The Board considered whether to proceed with the disclosure in the Exposure Draft for the sensitivity of a fair value estimated using a valuation technique to valuation assumptions not supported by observable market prices. The Board noted that fair values that are estimated by valuation techniques are more subjective than those established, eg from an observable market price, and agreed that users should be given information to assist them in assessing this subjectivity. The Board also noted that its intention was to require a much higher level of disclosures than seemed to be implied by the concerns expressed. The Board agreed to consider at a future meeting how the proposed requirement could be clarified.

Improvements to IAS 39 *Financial Instruments: Recognition and Measurement*

Fair value measurement guidance

The Board considered the fair value measurement guidance as proposed in the exposure draft of proposed Improvements to IAS 39. The Board tentatively agreed to the following:

(a) The proposal to use quoted prices in active markets to determine fair value:

- (i) to retain the proposed requirement in the Exposure Draft that quoted prices in active markets should be used to determine fair value, in preference to other valuation techniques, ie the existence of published price quotations in an active market is the best evidence of fair value and, when they exist, they are used to measure the financial asset or financial liability.
- (ii) to add guidance to address markets where a rate (not a price) is quoted. In that case the entity uses market quoted rates as inputs into a valuation model to determine the fair value.
- (iii) to retain the guidance proposed in the Exposure Draft about bid, ask, and mid-market prices, but to clarify what constitutes the bid-ask spread (eg if a quoted price does not consider counterparty credit risk, the entity adjusts for that risk in arriving at fair value).
- (iv) to clarify that the bid-ask spread is applied to any net open position (and not to each item in a portfolio that contains matching asset and liability positions).
- (v) to clarify that, when an entity has access to more than one active market (eg if an entity can sell an instrument in either a retail market or a wholesale market), the objective of fair value is to arrive at the price at which a transaction would occur at the balance sheet date in the most advantageous active market to which the entity has immediate access without cost and risk.
- (vi) to retain the proposed requirement in the Exposure Draft to preclude adjustments to fair value for blockage premiums/discounts, and/or liquidity, ie the fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price.
- (vii) to clarify that quoted market prices are adjusted for changes in factors that affect the price of the instrument and occurred between the time the price was last quoted and the close of the balance sheet date.
- (viii) to clarify that in active markets, quoted prices reflect actual market transactions, and that an active market is one in which transactions are regularly occurring.

(b) The proposal to use recent market transactions (in preference to a valuation technique) in an inactive market to determine fair value:

- (i) to simplify the fair value hierarchy by requiring that in an inactive market, an entity should use a valuation technique taking into consideration recent market transactions.

(c) The proposals for the use of valuation techniques in an inactive market to determine fair value:

- (i) to clarify that a dealer may recognise profit for an unrealised gain at the inception of a transaction involving an instrument that is not quoted in an active market only if the profit is evidenced by observable prices of other current market transactions or is based on a valuation technique incorporating observable market data. (The Board considered this issue in the context of, for example, an entity originating a financial instrument in one market, packaging a product, and laying off the risk in a different market.)

Pass-through arrangements

The Board continued its discussion about pass-through arrangements, ie contractual arrangements under which an entity collects cash flows on a financial asset and passes them through to another entity and which meet all three of the following conditions:

(a) the entity has no obligation to pay to eventual recipients unless it collects cash flows from the original asset.

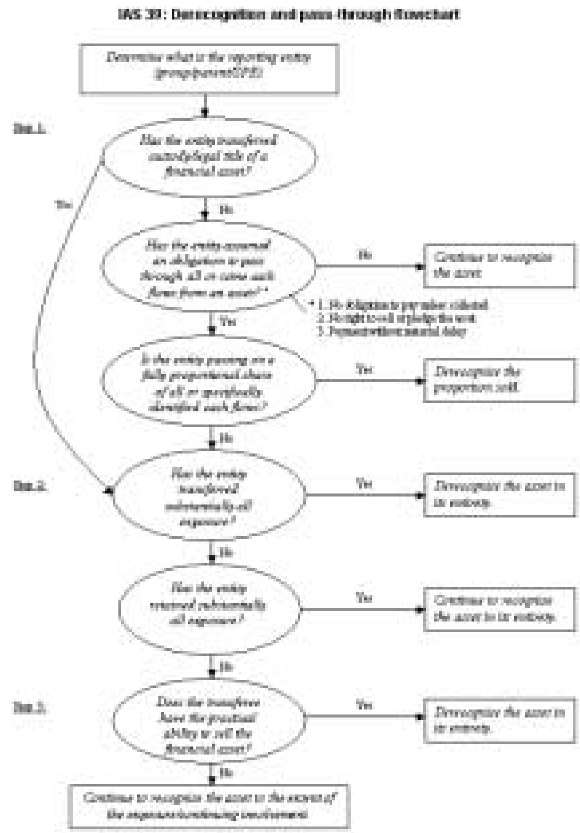
(b) the entity has no right to sell or pledge the original asset.

(c) the entity has an obligation to pass through collected cash flows from the original asset to eventual recipients without material delay.

At its meeting in May 2003, the Board tentatively agreed that if an entity passes on a fully proportional share of the collections of all or specifically identified cash flows under such an arrangement, the proportion sold qualifies for derecognition.

At its June 2003 meeting, the Board considered the accounting when the entity does not have a fully proportional share of the collected cash flows, ie arrangements with disproportionate risk-sharing such as an arrangement where the entity retains a subordinated residual interest. It also considered how the tests for pass-through arrangements interact with the derecognition model agreed at the May meeting.

The Board tentatively agreed the following model for derecognition and pass through arrangements:



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

The Board discussed whether IAS 39 should be amended so as to permit an entity to use fair value hedge accounting for a portfolio hedge of interest rate risk. In particular, the Board considered an approach that has been developed largely as a result of meetings between representatives of the Board and representatives of the Federation Bancaire de l'Union Européenne (FBE).

The Board tentatively agreed to publish an exposure draft that will propose the approach summarised in (a)-(h) below.

(a) The entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise both assets and liabilities.

(b) The entity analyses the portfolio into time periods, with the scheduling being based on expected, rather than contractual, repricing dates.

(c) Based on this analysis, the entity decides the amount it wishes to hedge. The entity designates assets (or liabilities) equal to the amount it wishes to hedge as the hedged item. For example, if an entity has assets of 100 and liabilities of 80 and decides to hedge 20 of assets, it will designate an amount of assets equal to 20 as the hedged item. The designation is of an amount (of euro, sterling, dollars or whatever currency) rather than of individual assets. All of the assets from which the hedged amount is drawn – ie all 100 of assets in the above example – must be items

   (i) whose fair value changes in response to the risk being hedged, and

   (ii) that could have qualified for fair value hedge accounting under IAS 39 had they been hedged individually.

   In addition, the time periods must be sufficiently narrow to ensure that all of the assets (or liabilities) contained in a time period are homogeneous with respect to the hedged risk – ie to ensure that the fair value of each item moves by about the same proportionate amount and in the same direction in response to changes in the hedged interest rate risk.

(d) The entity designates what interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the portfolio, such as a benchmark interest rate (eg LIBOR).

(e) The entity designates a hedging instrument for each time period. The hedging instrument may be a portfolio of derivatives (eg interest rate swaps) containing offsetting risk positions.

(f) The entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)). The result is recognised in profit or loss and in one of two separate line items in the balance sheet. More specifically relating to the balance sheet, if the hedged item in a particular time period is an asset, the change in fair value is reported in a separate line item within assets; if the hedged item in a particular time period is a liability, the change in fair value is reported in a separate line item within liabilities. This separate balance sheet line item is presented on the face of the balance sheet adjacent to the asset(s) or liability(ies) to which it relates. However, the change in fair value is not allocated to individual assets or liabilities nor to a separate classes of assets or liabilities.

(g) The entity measures the change in the fair value of the hedging instrument and recognises this as a gain or loss in profit or loss. It recognises the fair value of the hedging instrument as an asset or liability in the balance sheet.

(h) Ineffectiveness is the difference in profit or loss between the amount determined in (f) and that determined in (g).

The Board tentatively agreed that the designation of the amount hedged referred to in (c) should be such that if the entity changes its estimates of the time periods in which items are expected to repay or mature (eg because actual prepayments differ from estimated prepayments), ineffectiveness will arise regardless of whether the changes in estimates result in higher or lower amounts of assets or liabilities in a particular time period.

The Board noted that representatives of the Board plan to meet again with representatives of the FBE to discuss further how liabilities with a demand feature (such as demand deposits) would be treated under the approach described above. It also noted that the tentative decision it made at the April meeting – that the fair value of a financial liability that the holder can redeem on demand is not less than the amount payable on demand – implies that a demand deposit or other items with a demand feature could not be designated as the hedged item in a fair value hedge.

Cash instrument hedging

The Board considered whether to amend IAS 39 to permit an entity to designate a financial asset or financial liability other than a derivative (a 'cash instrument') as a hedging instrument in hedges of risks other than foreign currency risk. The Board tentatively agreed not to permit such designation.

Finalisation issues

The Board tentatively agreed to publish an exposure draft on a portfolio hedge of interest rate risk. It tentatively agreed that no other issues require re-exposure, subject to a further discussion on the interaction between IAS 32 and ED 2 *Share-based Payment*.

The Board also tentatively agreed to issue IAS 32 as quickly as possible, and to issue IAS 39 in two stages, as follows:

(a) The first stage is to issue IAS 39 as quickly as possible, and highlight paragraphs that are subject to re-exposure (ie as a result of the Exposure Draft on portfolio hedging of interest rate risk).

(b) The second stage is to issue an amendment to IAS 39 that would reflect any changes agreed from the re-exposure process.

Following a letter from the Accounting Standards Board of Japan, the Board revisited the issue of reversals of impairment for equity instruments classified as available for sale. The Board tentatively agreed to revert to the position in the Exposure Draft for equity instruments, namely that impairment should be recognised if there is objective evidence of impairment (eg a significant and prolonged decline in fair value) and if the fair value subsequently increases, the increase in value is reported in equity and not as a reversal of the impairment loss through profit or loss.

The Board also considered a decision summary of the Board's tentative decisions to date, and tentatively agreed to proceed on the basis of those decisions.

IFRIC issues

Accounting for reimbursements

The Board continued its discussions on accounting for the asset that arises from a right to reimbursements of expenditure, where the expenditure to be reimbursed is required to settle a liability that had been recognised as a provision under IAS 37. The Board considered a number of alternative ways to achieve the IFRIC's preferred treatment that such assets be accounted for at fair value with changes in fair value recognised in the income statement. The Board noted that this treatment of the right to receive reimbursement would have the advantage that it would be consistent with how the related liability for the decommissioning obligation is accounted for under IAS 37.

The Board tentatively agreed to amend the scope of IAS 39 by adding an exclusion in paragraph 1 of IAS 39 for "rights to payments to reimburse the entity for expenditure it is required to make to settle a liability which it has recognised as a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*".

The "closely related" criterion in IAS 39

The Board discussed whether the IFRIC should issue guidance on how to evaluate when the "closely related" criterion for determining whether an embedded derivative is separated from its host contract is met (paragraph 23(a) of IAS 39). The Board noted that to change to the approach in IAS 39 would go beyond giving an Interpretation of existing guidance. Furthermore, it did not believe that the IFRIC would be able to provide timely input to the Board's project on Improvements to IAS 39, in view of the need to finalise IAS 39 in the near future. Therefore the Board concluded that the IFRIC should not add this matter to its agenda. Instead, the Board directed the staff to consider whether the meaning of "closely related" can be clarified as part of its consideration of the other issues to be discussed in finalising IAS 39.

Insurance contracts (phase I)

The Board discussed the following matters arising from Board members' review of a pre-ballot draft of the exposure draft for phase I of the Insurance Contracts project:

- the definition of an insurance contract
- financial liabilities with a demand feature
- the temporary exemption from the "hierarchy" in [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Definition of an insurance contract

The draft exposure draft defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.'

The draft defines insurance risk as risk other than financial risk. Financial risk is defined as the 'risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable'. This list of variables is the same as the list of variables in IAS 39's definition of a derivative, except that it uses 'similar variable' (as in current IAS 39) rather than 'other variable' (as in the June 2002 exposure draft of amendments to IAS 39).

The Board agreed to replace the words 'similar variable' with the phrase 'other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract'. This phrase distinguishes two types of non-financial variable:

- some non-financial variables are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. The risk of changes in these variables is an insurance risk.
- other non-financial variables are not specific to a party to the contract, such as an index of earthquake losses in particular region or an index of temperatures. The risk of changes in these variables is a financial risk.

The Board noted the implications of this distinction for residual value insurance and residual value guarantees (other than those residual value guarantees within the scope of IAS 17 *Leases*). The risk of changes in the fair value of a non-financial asset held by a party to a contract is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable). Therefore, that risk is insurance risk, unless the guarantee does not compensate the beneficiary for changes in the condition of the beneficiary's asset.

The Board also agreed to clarify that the insurance risk accepted by the insurer must be a pre-existing risk that the policyholder transferred to the insurer, rather than a new risk created by the contract. (Consider, for example, a contract that requires the issuer to pay the holder one million euros if the holder suffers a loss of one euro. In this contract, the holder transfers to the insurer the insignificant risk of losing one euro. At the same time, the contract creates non-insurance risk that the issuer will need to pay € 999,999 if the insured event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.)

Financial liabilities with a demand feature

The Board confirmed the following two decisions:

(a) In March 2003, the Board discussed the treatment of non-insurance financial instruments ('investment contracts') under which the investor holds cancellation or renewal rights. The Board agreed that the fair value of the issuer's liability should be based on the expected (ie probability-weighted) surrender patterns and include all associated cash flows, such as deposits, repayments, future front-end fees and surrender charges. The Board agreed not to address the criteria for distinguishing new contracts from continuation of an existing contract until phase II of the project on insurance contracts.

(b) In April 2003, the Board agreed 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.

In June 2003, the Board confirmed that the measurement agreed in April 2003 overrides a liability measurement based on expected surrender patterns if the latter amount is less than the amount payable on demand. In addition, the Board noted that IAS 38 *Intangible Assets* applies to intangible assets, if any, associated with investment contracts. In practice, internally generated intangible assets associated with those contracts are unlikely to qualify for recognition as assets under IAS 38.

Temporary exemption from the "hierarchy" in IAS 8

Paragraphs 5 and 6 of [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify the "hierarchy" an entity should use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, the proposals in the Exposure Draft on insurance contracts exempt an insurer from applying those criteria during phase I of this project to most aspects of its existing accounting policies for insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.

In June 2003, the Board agreed that the temporary exemption from the hierarchy should apply only for accounting periods beginning before 1 January 2007. The Board also confirmed its commitment to completing phase II of this project without delay, after thorough investigation of all relevant conceptual and practical questions and completion of a full and extensive due process.

The Board decided not to transfer to the exposure draft any of the proposed Implementation Guidance on disclosure.

Next steps

The Board approved the Exposure Draft for publication, subject to written ballot on the final text. The Board aims to publish the exposure draft at the end of July 2003, with a comment deadline of 31 October 2003. The Board plans to issue an IFRS by the end of March 2004.

Reporting comprehensive income

The Board discussed the implications of the feedback received from field tests of its proposed comprehensive income statement format for the project generally. Some preparers and users consider the alignment of subtotals in the total column with management's internal reporting (ie with the 'business model') to be of great importance. A provisional approach being considered by the FASB permitting reporting comprehensive income 'through the eyes of management' was understood to be a response to this issue, but one that raised difficulties related to distinguishing 'business activities' and 'other'. The Board noted that some users and preparers consider 'earnings' (however defined) to be an important measure within comprehensive income. The Board acknowledged that it needed to communicate its objectives and principles for reporting comprehensive income more effectively and to educate its constituents on how the Board's proposals would achieve those objectives and principles.

The Board reconsidered the proposed comprehensive income statement format and reached the following tentative conclusions:

(a) Recognised changes in assets and liabilities should be recognised in a single statement. The Board acknowledged that this would change the current measurement of net income and the associated practice of recycling.

(b) Inventory impairments should be reported as remeasurements.

(c) Write-downs of accounts receivable should be reported as remeasurements within operating profit and not within financial income. This was a change from the Board's prior decision. The Board concluded that, in the light of the close relationship between revenues and write-downs of accounts receivable, both should be reported within operating profit. The Board noted that this treatment is consistent with the definition of operating in the cash flow statement.

(d) Service cost, past service cost (arising on plan amendments) and interest costs are reported as income flows before remeasurement, Actuarial gains and losses on obligations and plan settlements and curtailments are reported as remeasurements. The Board agreed that the exposure draft should explain the presentation requirements under the current IAS 19 *Employee Benefits* and not just those under any possible revision or replacement of IAS 19.

(e) The initial recognition of a provision and subsequent interest costs (including the unwinding of a discount) are reported in income before remeasurements, while remeasurements of the liability due to changes in the original estimates are remeasurements.

(f) The 'other business profit' category should be retained as proposed–ie to include disposal gains and losses, property, plant and equipment remeasurements, investment property fair value changes, goodwill and foreign exchange gains and losses on net investment. However, the Board agreed that the staff should give further consideration to whether foreign exchange gains and losses on net investment should be displayed elsewhere, for example further down the statement of comprehensive income.

(g) Income from associates should be reported within financial income, net of income tax expense recognised by the associate.

(h) All liabilities provide finance to an entity. Accordingly, financing should include all recognised interest expense including interest accrued on various discounted provisions.

(i) The business profit subtotal should be required.

Further discussion of the distinction between financing expenses and financial income will be required. In particular, the following issues will be considered at a future meeting: the possible inclusion of income from certain financial assets within financing and the presentation of the financial and financing categories for financial institutions.

The Board will also reconsider the following issues: income taxes, earnings and earnings per share, presentation of items of comprehensive income by function *versus* nature, line captions, presentation on the face of the statement and adoption date.

Revenue recognition

The Board discussed a proposed conceptual model for analysing whether assets and liabilities arise from contractual rights and obligations and how to measure those assets and liabilities. The model is relevant to identifying and measuring revenues, because the Board has agreed to define revenues as a subset of changes in assets and liabilities. The Board focused on analysing the economic effects of contractual rights and obligations—ie whether assets and liabilities *arise*—rather than whether and when such items should be *recognised*.

The Board considered contractual rights and obligations of the following type:

(a) *Conditional*—performance is subject to the occurrence of an event that is not certain to occur (such as performance by the counterparty to the contract);

(b) *Unconditional*—nothing other than the passage of time is required to make its performance due; and

(c) *Mature*—performance is not subject to any event, not even the passage of time. It is due immediately.

The key distinction is between conditional and unconditional rights and obligations. An example is a contractual guarantee of a single adverse event. From the inception of the contract, the guarantor has the following obligations:

(a) an *unconditional* obligation to "stand ready" to sacrifice economic benefits if the guaranteed event occurs; and

(b) a *conditional* obligation to make that sacrifice of economic benefits.

The guarantor provides a service to the holder of the guarantee by standing ready to make that sacrifice until the earlier of when the guaranteed event occurs or the term of the guarantee expires.

The Board generally supported the proposed conceptual model. It tentatively agreed that:

(a) conditional rights and obligations do not meet the definitions of an asset and a liability;

(b) unconditional rights and mature rights meet the definition of an asset if they are enforceable and give access to future economic benefits; and

(c) 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.

The unconditional rights and obligations that exist until either party to a contract performs its stated conditional obligation are described as "pre-performance assets and liabilities". The Board tentatively agreed that for sale-purchase contracts, pre-performance assets and liabilities are akin to call options and put options.

The unconditional rights and obligations that exist after either party to a contract performs its stated conditional obligation are described as "post-performance assets and liabilities". The Board tentatively agreed that post-performance assets and liabilities are familiar assets and liabilities such as accounts receivable, accounts payable and purchased inventories.

The Board also tentatively agreed that:

(a) pre-performance assets and liabilities should be measured at their fair values at initial recognition;

(b) subsequent changes in the fair values of pre-performance assets and liabilities should be recognised as revenues or expenses; and

(c) post-performance assets and liabilities should be measured at their fair values at initial recognition.

These tentative decisions on measurement are based on the Board's decision to use fair value as the measurement attribute for analysing revenue recognition issues. They are subject to review when the Board makes decisions in its Measurement project.

The Board asked the staff to prepare an outline of the project's future steps for consideration at its meeting in July. The Board also noted that future work on contractual rights and obligations will include considering:

(a) the implications of remedies for breach of contract that include specific performance rather than monetary damages;

(b) when and how the assets and liabilities arising from unconditional and mature contractual rights and obligations should be recognised in financial statements; and

(c) the application of the proposed conceptual model to long-term contracts such as construction contracts.

The Board will discuss at a future meeting the remaining outstanding issues from its May 2003 meeting relating to the amount of revenues to be recognised.

Share-based payment

The Board continued its re-deliberations of the proposals in ED 2 *Share-based Payment*, in the light of comments received. At this meeting, the Board began discussing various valuation issues, including reviewing an analysis of comments received in respect of these issues (see summary below). The Board was not asked to reach any tentative decisions at this meeting and will continue its discussions at the July Board meeting.

Measurement of equity-settled transactions with employees

ED 2 proposed that an entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, because the latter fair value is more readily determinable. Of those respondents who addressed this issue, most agreed with the proposal in ED 2. However, some respondents preferred a rebuttable presumption, rather than a mandatory requirement, to allow for situations in which the fair value of the employee services received is more readily determinable than the fair value of the equity instruments granted. Others commented that the proposed approach was too restrictive and that entities should be free to measure whichever fair value is more reliably determinable. However, some respondents explicitly refuted this idea.

Option pricing models

ED 2 proposed that, in the absence of a market price, the entity should estimate the fair value of options granted, by applying an option pricing model. Most respondents who addressed this issue agreed that an option pricing model should be applied to estimate the fair value of options granted. However, some respondents disagreed in the case of options granted by unlisted and newly listed entities, and some respondents disagreed with applying an option pricing model to employee share options. Some respondents argued that the IFRS should specify which option pricing model should be applied, while other respondents argued that the IFRS should not favour any particular model. Some respondents suggested further research into option pricing models was required. Some believed that a substantial amount of guidance on applying option pricing models should be added to the IFRS, whereas others argued that any guidance should be kept to a minimum, to allow for future developments in valuation methodologies. Some respondents noted that the IFRS is an accounting standard and should not seek to become a financial textbook on option valuation.

Non-transferability and inability to exercise during the vesting period

ED 2 proposed that, if an option was non-transferable, the expected life of the option rather than its contracted life should be used in applying an option pricing model. ED 2 also proposed requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period. Of respondents who addressed these issues, most agreed with the proposals in ED 2. However, some respondents disagreed or expressed concerns. For example, some respondents regarded the use of expected life as subjective, too simplistic or an inadequate means of allowing for the effects of nontransferability. Some respondents argued that the use of expected life would overstate the option's value, whereas others argued that it would understate the value. Some respondents believed that the IFRS should not prescribe the method of adjusting for non-transferability.

Reload feature

ED 2 proposed that a reload feature should be taken into account, where practicable, when an entity measures the fair value of the options granted. However, if the reload feature is not taken into account in the measurement of the fair value of the options granted, ED 2 proposed that the reload option granted should be accounted for as a new option grant. Most respondents who addressed this issue agreed with the proposals in ED 2. However, some respondents believed that the standard should not permit a choice of methods. Some respondents argued that a reload feature should always be included in the grant date valuation, whereas others disagreed and argued that all reloads should be accounted for as a new option grant.

Other features of employee share options

ED 2 proposed requirements for taking into account various features common to employee share options, such as non-transferability, inability to exercise the option during the vesting period, and vesting conditions. Respondents were asked whether there are other common features of employee share options for which the IFRS should specify requirements. Some respondents explicitly stated that were no other features for which the IFRS should specify requirements. Other respondents suggested a variety of other features that they thought should be covered in the IFRS.

Level of prescription in the IFRS

ED 2 does not contain prescriptive guidance on the estimation of the fair value of options. That is, consistent with the Board's objective of setting principles-based standards and to allow for future developments in valuation methodologies. Most respondents who addressed this issue agreed with the proposed approach. However, some respondents disagreed or expressed reservations, because they thought that additional prescriptive guidance should be given. In contrast, some respondents commented that ED 2 already contained too much prescriptive guidance. Some respondents emphasised the importance of disclosure of the valuation model applied and significant assumptions made in estimating the fair value of share options.

Meeting dates: 2003

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

22—24 July ***Note new dates!***

17—19 September; 22 and 23 September‡

22—24 October, Toronto, Canada

17—21 November†

17—19 December

† Includes a meeting with the Standards Advisory Council

‡ Includes meetings with partner and other national standard-setters